



RECOMMENDED PRACTICE

Improving the Effectiveness of Fund Accounting (2004)

Background. One important objective of external financial reporting is to help users assess accountability by “assisting in determining compliance with finance-related laws, rules, and regulations.”¹ To achieve this goal, state and local governments organize and operate their accounting systems on a fund basis.²

State and local governments frequently establish a large number of “funds” for internal accounting purposes. Having internal “funds” often are useful or necessary to provide the level of detail needed to ensure and demonstrate legal compliance. In this regard, however, the goals of accounting differ somewhat from the objectives of financial reporting. Whereas an accounting system must collect *all* of the data needed to ensure and demonstrate legal compliance, financial reporting should be concerned only with those aspects of compliance that are of importance to users of *general purpose* external financial reports. Consequently, not every internal “fund” should automatically be classified as a *fund* for purposes of external financial reporting.

As specifically noted in the authoritative accounting and financial reporting standards, the use of unnecessary funds for financial reporting purposes, can “result in inflexibility, undue complexity, and inefficient financial administration.” Accordingly, those same authoritative standards state that “only the minimum number of funds consistent with legal and operating requirements should be established.”³ Unfortunately, many state and local governments continue to report more funds in their comprehensive annual financial report than are truly necessary to achieve the goals of general purpose external financial reporting, thereby needlessly adding to the length and complexity of that report and potentially increasing audit fees.

Recommendation. GFOA recommends that every state or local government that uses fund accounting⁴ establish clear criteria for determining whether a given internal “fund” should be classified and reported as an individual *fund* in the government’s comprehensive annual financial report (CAFR).⁵ The application of these criteria to individual internal “funds” of the government should be documented.

Whenever it is possible to do so without sacrificing the goals of fund accounting, similar internal “funds” should be combined into a single *fund* for external financial reporting purposes. For example:

¹ Governmental Accounting Standards Board (GASB), Concepts Statement No. 1, *Objectives of Financial Reporting*, paragraph 32.

² National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 2.

³ NCGA Statement 1, paragraph 4.

⁴ This guidance is not intended to apply to most governmental units that are accounted for as stand-alone business-type activities.

⁵ For example, “each significant nonhomogeneous activity supported by a charge for services and accounted for as a business-type activity should be reported as a separate enterprise fund.”

- When a government has numerous debt issues outstanding, a single debt service fund could be used in many instances for all of the smaller debt issues
- Governments with numerous capital projects may wish to consider combining their less significant projects into a single capital projects fund.
- Grants for similar purposes (e.g., special education) could be combined into a single special revenue fund. In many cases, activities now reported in a separate fund in the CAFR might better be included as part of the general fund.⁶
- Governments could limit their use of internal service fund accounting to situations where the difference on charges to other funds between accrual and modified accrual accounting is expected to be significant.

Every state or local government that uses fund accounting should periodically⁷ undertake a comprehensive evaluation of its fund structure to ensure that individual *funds* that have become superfluous are eliminated as such from the CAFR.⁸ Elected officials should be educated to the fact that accountability may be achieved effectively and efficiently in many instances solely by the use of internal “funds.”

Recommended by the GFOA’s Executive Board on March 26, 2004.

⁶ “The general fund is the chief operating fund of a state or local government. GAAP prescribe that the general fund be used ‘to account for all financial resources except those required to be accounted for in another fund.’ That is, it is presumed that all of a government’s activities are reported in the general fund unless there is a compelling reason to report an activity in some other fund type.” *Governmental Accounting, Auditing, and Financial Reporting*, page 18.

⁷ The periodic comprehensive evaluation of a government’s fund structure should not occur so frequently as to disrupt the continuity of that structure. Thus, while a comprehensive evaluation should occur at a regular, predetermined interval, that interval normally would be expected to be longer than one year.

⁸ For example, a fund that originally was established to account for what was once a significant grant program that has since become relatively insignificant..